



Near-term impacts of low interest rates on life insurers

by Tara Hansen and Rob Barg

Within the life insurance market, there has been a great deal of speculation about the long-term impact of low interest rates on future profits. Analysts and industry observers have warned that insurers may lose money as investment margins shrink, the cost of equity hedging increases and defensive risk management actions become necessary. Given the concern that low interest rates may be here to stay, supported by the Federal Reserve's pledge to keep short-term interest rates near zero at least until 2013, many questions have been raised about the long-term implications to insurers.

However, insurers must recognize that while the lower cash returns will emerge over the longer term, some of the financial reporting impacts will be felt in the very near term. In fact, the impact could be seen on insurer's financial reports as early as Q3 2011, and certainly by year-end 2011. While insurers must regularly update their assumptions, the impact of assumption updates on this year's balance sheets and income statements will be felt more acutely than in previous years. These significant shifts will inevitably lead to more intense scrutiny and more questions from analysts during upcoming calls. In other words, to some degree the future is now when it comes to the impact of low interest rates on insurers.

In planning for earnings calls, CFOs must make themselves aware of the 10 financial statement items and concepts listed in the following pages. All of these items will be reflected on the balance sheet; however, some flow through income statements, while others flow through other comprehensive income (OCI). Those items that affect earnings should be the highest priority areas for life insurers. It's important to remember, however, that the nature of a carrier's product and asset portfolio will dictate which items are most important. In some areas, noted below, they should also prepare for significant dialogue among finance and accounting teams, actuaries and line-of-business executives, as well as the analyst community.

It is useful to group the near-term impacts of low interest rates into three primary categories:

- ▶ Lower projected profits
- ▶ Discount rate changes
- ▶ Shadow impacts

Lower projected profits

1. FAS 97 DAC unlocking. Perhaps the most obvious impact of lower interest rates is the pressure they will put on profit margins for interest-sensitive products. Most companies update their future assumptions for interest-sensitive products once a year or more often, as the environment dictates. With market rates falling close to minimum crediting rate levels, insurers must acknowledge the likelihood of lower future profits and hence accelerate DAC amortization on interest-sensitive products as early as Q3 2011 or year-end.

DAC assets are often a contentious area for management and analysts; to avoid unpleasant surprises regarding DAC amortization, CFOs should proactively engage stakeholders in addressing these issues and shaping the right communication plan.

2. SOP 03-1 increases. Similar to FAS 97 unlocking, life insurers must update assumptions about the impact of future interest rates on liabilities, particularly with regard to universal life products with secondary guarantees. With strong indications that interest rates will stay low,

reflect emerging experience and anticipated policyholder behavior. The algorithms often attempt to capture policyholders' desire to lapse policies in times of high interest rates and to persist with (or invest more in) policies that have attractive guarantees or in the money options during times of low interest rates.

As companies revise their projections in light of the low interest rate environment, these dynamic policyholder behavior algorithms will likely predict lower future lapses. For lapse-supported products, the models might project future losses or simply lower projected margins. For products with high interest rate guarantees (e.g., 3%-4%), models might also project losses as a result of lower lapse rates and investment margins that are near zero or even negative. As this lower profitability is incorporated into the projection of future profits, the DAC amortization and SOP 03-1 reserve increases on interest-sensitive products may be exacerbated by the second-order effects of policyholder behavior assumptions.

4. Recoverability. Companies can only defer acquisition costs associated with new business generated to the extent that these costs are recoverable from future profits on that new business. Since interest rates fell steeply and quickly in 2011, many companies have not yet repriced their products. As a result, some products are being sold at prices based on interest rate assumptions that no longer apply. If, after adjusting assumptions, future profits are not high enough to recover the acquisition costs (such as agent's commissions), companies might have to accelerate the amortization of DAC and incur additional costs today instead of deferring them. Here again, the prospect of depressed future profits compels insurers to incur these costs sooner rather than later. In other words, the long-term outlook has immediate-term impact.

5. Non-guaranteed elements in DAC assumptions. Reacting to the low interest rates, several carriers are considering adjustments to certain non-guaranteed elements of contracts to prevent future losses of profit on those blocks of business. Although changes to these elements may preserve some future profitability, companies should consider the status and likelihood of management actions and any required regulatory approvals when setting their best estimate assumptions. Insurers should not assume that rate changes are a sure bet, given the current regulatory environment and economic outlook. Further, many companies have

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interest margins are likely to be squeezed for some time to come and the expectation of lower future assessments will lead to an increase in the SOP 03-1 reserve in the current period. This increase in the reserve will be partly offset by lower DAC amortization due to reduced estimated gross profits in the current period when reserves are strengthened.

3. Policyholder behavior. Lower interest rates may also impact policyholder behavior. In some cases, the behavioral changes may be unexpected (thanks to overall economic uncertainty and low consumer confidence) or not tracked precisely (due to complex product design). In recent years, companies have implemented more sophisticated algorithms and complex models to better

a variety of competitive considerations, determination policies, board directives, contract language, Actuarial Standards of Practice, insurance laws and regulations, and other factors that bear on management decisions related to the ongoing management of non-guaranteed elements.

6. Goodwill impairments. Companies with significant goodwill balances must test these assets at least annually for impairment. Such tests compare the goodwill balance to the best estimate of the present value of distributable earnings from new business.

Although lower interest rates may lower discount rates, which will raise the present value of the earnings, they also reduce future profits by decreasing future spreads. In practice, more uncertainty in the marketplace is leading to risk discount rates, which have not decreased as expected. Additionally, companies must recognize a potential reduction in the sales capacity for interest rate-sensitive products and/or potentially lower sales of these products in the current environment.

As a result, even though lower discount rates would increase the present value of earnings, the lower sales capacity and reduced interest rate spreads may significantly weaken future earnings and therefore end up reducing the total present value. In such a case, insurers may be forced to impair some or all of their goodwill balances.

While goodwill impairments can be contentious within many companies, they are of great interest to analysts. It is imperative that senior finance leaders in life insurance organizations engage with the relevant stakeholders to address this item in advance of earnings calls.

Discount rate changes

7. FAS 60 loss recognition. So far, we have discussed how changes in interest rate assumptions might lead to accelerated DAC amortization and reserve increases associated with interest-sensitive business. However, low interest rates may also impact the DAC and reserves associated with non-interest sensitive business. Payout annuities with life contingent payments are one product class where FAS 60 loss recognition issues might occur, leading to increased reserves.

At least once a year, companies compare their net GAAP liability for non-interest sensitive business against their

best estimate of the net liability. The net GAAP liability reflects assumptions that are locked in at policy issue. For traditional policies issued prior to 2008, these locked-in interest rates could be near 6%-7%, considerably higher than current prevailing interest rates.

When testing the currently held liability, companies compare it to the liability calculated using their best estimate of future portfolio rates. If the best estimate net GAAP liability is higher than the reported net GAAP liability (because of lower interest rates or other factors), companies will need to either write off the DAC associated with the business or, if the DAC is insufficient, write up the liability in terms of increased reserves.

8. Discount rates (FAS 133/claim reserves). Several balances for insurers rely on either current market observable interest rates or the best estimate of future interest rates. These include balances such as FAS 133 liabilities and claim reserves subject to discounting.

A lower interest rate environment will lower the discount rate and increase the liability balances. The impact on FAS 133 balances will be more severe than the impact on claim reserves, since insurers must reflect the current risk-free rates in the former and can use expected future portfolio rates in the latter.

Shadow impacts

9. Shadow adjustments. This impact applies to interest-sensitive business (FAS 97 and FAS 120) whenever unrealized gains or losses are present in available for-sale assets. Interest rate declines have led to significant unrealized gains for many insurers. Because most insurers' assets are classified as available for-sale and marked to market, the unrealized gains are reflected on the balance sheet.

To ensure consistency with the assets being marked to market on the balance sheet, insurers are obligated to adjust the DAC balance so that it accurately reflects the unrealized gains and matches up to the invested assets on the balance sheet. The large unrealized gains held by insurers will lead to significant shadow DAC adjustments, lowering the value of DAC on the balance sheet. These "shadow adjustments" will not impact earnings (since they go through OCI); however, they will impact insurer GAAP equity.

10. Shadow loss recognition. Shadow loss recognition has been an uncommon and somewhat complex accounting adjustment that applies to non-interest sensitive business (FAS 60). It is important to remember that such adjustments will not impact earnings; rather, they will pass through OCI and only impact GAAP equity. Even though companies might pass loss recognition (i.e., the best estimate liability is lower than the reported net GAAP liability), they must also determine whether the sale of all existing available for-sale assets and reinvestment at current prevailing rates would lead to liabilities that are greater than the reported net GAAP liability. If they are above that level, an equity-only DAC write off or a liability write-up is needed. The point is to confirm that sufficient reserves are in place after allowing for reinvestments at lower yields. Many companies perform this test by comparing the unrealized gain on the assets to the margin in the liability (net GAAP liability minus the best estimate reserve).

Products that are particularly susceptible to these types of adjustments include long-term care and single premium immediate annuity or group pension blocks, as well as blocks of business that have previously experienced loss recognition events.

Conclusion

Life insurance executives who have been considering low interest rates mainly in terms of their long-term impacts on future profits must reorient their view toward nearer-term horizons. Interestingly, by making immediate adjustments to assumptions, insurers will gain a clearer view of the impact of the longer-term outlook.

The bottom line is that insurers must prepare now for the financial statement impacts for year-end 2011 and related earnings calls for public companies. Low interest rates are very much on the minds of analysts and the investment community, which have already begun raising questions. Finance and business executives must arm themselves with accurate information, analyze the business impacts, develop management action plans and shape a proactive communication strategy. That way, management can demonstrate their plans to manage risk and continue optimizing enterprise value in the face of low interest rates that may be here to stay.

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